Western Wireless

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Competitive Universal Service: Myths and Realities

The inquiry commenced by the Federal-State Joint Board on Universal Service calls for a serious effort to develop new policies to advance both of the critical goals of the Telecommunications Act of 1996: fostering universal service and promoting competition, both of which should benefit rural consumers. Western Wireless has suggested that a new **Competitive Universal Service Task Force** be convened to assist the Joint Board with analyzing the difficult issues and work toward building consensus.

But instead of making a serious effort to address the issues, some parties persist in perpetuating unfounded myths regarding universal service. This paper attempts to debunk these persistent untruths.

Myth #1: *The primary driver inflating the universal service fund is support to competitive eligible telecommunications carriers.*

Fact: ILECs continue to receive over 96% of high-cost funds, and the growth in funding to ILECs accounts for 90% of the total growth of the fund.

- The most recent USAC data show that competitive ETCs receive just 3.7% of all federal high-cost fund distributions. ILECs receive the remaining 96.3%.
- The data show a $1.36 Billion growth in projected annual high-cost universal service funds to ILECs over the past seven calendar quarters, as opposed to a $121 million increase in projected annual high-cost funds to competitive ETCs.
- The primary drivers of the growth in the fund are the RTF and MAG decisions, both designed to enable rural ILECs to recover their revenue requirements established under the rate-of-return form of regulation (as well as the CALLS plan, designed to preserve revenue-neutrality for the large ILECs' at the time of access charges reform.)
- The rural ILECs have provided <u>no</u> support for their exaggerated claims regarding the potential future growth of the fund.
- If you start by identifying the wrong problem, you will certainly fall upon the wrong solution. **CETCs are not causing the fund-growth problem; excessive funding to rate of return ILECs is the problem.**
  - It is a painful problem that the FCC has postponed dealing with time and again, but can postpone no longer.
  - However, "solutions" geared to reducing funding to CETCs will do nothing to address the real problem.

Myth #2: *USF support funds received by rural ILECs constitute "genuine cost recovery."*

Fact: The current system of USF support for rural ILECs is based on "rate of return" (or "rate base") regulation, a system that Congress specifically rejected in Section 252(d) of the 1996 Act, and that the FCC has long held to be inefficient and anti-competitive.

- Rate of return (ROR) regulation depends on "backward-looking" accounting costs. But there's a consensus among economists that forward-looking costs are a more accurate way to measure costs. Forward-looking cost models can be developed that measure rural ILEC costs more accurately than the FCC's current model.

- Even if one were to accept the theory of backward-looking costs, there is good reason to think that the **current version of rate of return regulation does not appropriately "recover genuine costs."**

    - ROR regulation depends on accurate accounting and bookkeeping by the ILECs. The FCC has never audited the books of the rural ILECs, and so there's no reason to presume the accuracy of the regulatory books (kept separately from the books kept for tax/securities law purposes), particularly in this "era of corporate governance problems and accounting depredations." (Copps/Adelstein statement, FCC 03-111, released 5/19/03).

    - ROR regulation is designed to assure ILECs an 11.25% rate of return – a figure set over a decade ago which may well be excessive today. Moreover, a large number of ILECs are earning in excess of the 11.25% figure.

    - The FCC rules governing ROR regulation (Parts 32, 36, and 69) were designed to generate cross-subsidies and/or to shift revenues between the state and federal jurisdictions. The revenues driven by these existing rules do not necessarily have any relationship to "reality."

- **ROR regulation creates incentives for ILECs to operate inefficiently**, because it entitles them to recovery of every dollar invested regardless of how inefficient the investment. Consumers nationwide are paying excessive contributions into the USF to support inefficient, excessive ROR-driven disbursements.

- **ROR regulation harms competition.** There can be no level competitive playing field when the incumbent not only enjoys the natural advantages of incumbency, but also enjoys a government-guaranteed recovery of return on investment, while CETCs' investments are completely at risk.

- Given the lack of credibility of the existing system of ROR regulation, policy-makers should not be fooled by the apparent precision of what in reality are arbitrary amounts of money that ILECs receive from the USF.

Myth #3: *USF support funds received by CETCs constitute an "undeserved windfall."*

Fact: There is no truth to some parties' mischaracterizion of portable USF disbursements to CETCs as an "undeserved windfall" or "all margin." In fact, CETCs, like ILECs, are required by law to use the USF funds they receive to support and maintain universal service, and are doing so, since the costs of network infrastructure are higher in rural areas, and the population base over which to spread fixed costs is smaller.

- But if there were any merit to this allegation, exactly the same could fairly be said of the funds to ILECs, who receive over 96% of federal high-cost funds.

Myth #4: *Many state commissions have been quick to designate competitive carriers as ETCs in rural telco areas with little or no public interest analysis.*

Fact: State PUCs typically conduct extensive, rigorous, and thorough proceedings on ETC applications. These proceedings typically last 6 months to 2 years or longer. For the most part, the state PUCs are doing a superb job of rigorously managing this process and conducting the analysis required by the federal Act.

- The most important public interest factor is whether consumers in a given area would benefit from the entry of a competitive carrier in the universal service marketplace. It is not surprising that the answer is usually yes. In practice, almost no rural area is "too small" to sustain competition.

- Rural ILECs argue that they will be unable to provide service when competitive ETCs enter their areas, but they have never provided evidence that this is the case. In reality, no ILEC has ever exited a market in response to competitive entry.

    - A separate proceeding is required under Section 214(e)(4) for a carrier to relinquish its ETC status. There is no basis to conduct the 214(e)(4) analysis at the time that an entrant seeks ETC status.

Myth #5: *Wireless carriers have no need for USF funds to compete in rural areas: they entered rural markets based on a business model that did not contemplate USF funds; and today, mostly with no USF funds, wireless carriers are already competing effectively, and are charging rates in rural areas comparable to their rates in urban areas.*

Fact: Rural wireless carriers need universal service support to compete effectively in rural areas and bring benefits to rural consumers.

- Without universal service support, wireless carriers in high-cost rural areas lack the resources to build additional cell sites and make other network improvements to improve service quality.
  - Rural consumers will benefit from more robust wireless networks that can provide ubiquitous access to mobile service, including E-911, while also providing a facilities-based competitive alternative to the ILECs' offerings.
- Without universal service support, wireless carriers cannot offer pricing plans that compete head-to-head against the ILECs' offerings.
  - Universal service support is enabling wireless ETCs to begin introducing rate plans that compete directly against rural ILECs' offerings, or that provide pricing benefits such as free or low-price long-distance service (as well as the benefits of mobility). Such price competition is likely to intensify in the future, and clearly benefits rural consumers.
- **Portability of support is necessary to remove a barrier to entry** that was artificially imposed by the regulatory regime in place before the 1996 Act, in which only ILECs received support. Courts of appeals have confirmed that portability of universal service support is mandated by the 1996 Act and the competitive neutrality principle, and the FCC has consistently reached the conclusion in numerous orders over the past 6 years.
  - To ensure a level competitive playing field, in which the universal service system gives neither ILECs nor competitors artificial advantages, all carriers must receive identical amounts of support per customer they serve.
  - Competitive incentives and market discipline would be skewed if a subsidy were provided only to one ETC but not to another, or in a greater amount to one ETC than another. If the ILEC were to receive X dollars more than the CETC, then the ILEC could be up to X dollars per month less efficient than the CETC and still have marketplace advantages conferred by nothing other than the unequal universal service system.

Myth #6: *When competitive carriers receive support for serving customers that already take service from an ILEC, the support is "duplicative" and unnecessary.*

Fact: As wireless/wireline competition grows in importance, competition in the market for so-called "second lines" is an important arena for competition – and for universal service and connectivity.

- When members of a household choose to purchase a "second" line from an ILEC, the carrier receives support for all lines it provides. If the consumers choose, instead, to purchase a "second" line from a competitive ETC, there is no valid, competitively neutral reason not to provide to the competitive ETCs the same support that the ILEC would receive.

- Just because wireline was there first does not justify a presumption that the wireline phone is always the "primary" line.

  - Many consumers – in rural areas and elsewhere – use their wireless phones as their primary phones, and consumers are placing an increasing proportion of their calls on their wireless phones.

  - There is no competitively neutral, administratively feasible means to distinguish between "primary" and "secondary" lines.

- The Act provides that rural consumers should have access to services that are reasonably comparable to those available in urban areas. Urban consumers have access to reasonably priced first lines *and* "second lines" – rural consumers are entitled to comparable access.

- The objective cited by most parties that support primary line restrictions (most rural ILECs oppose them) is to control USF growth – but if that is the objective, there are competitively neutral ways to achieve that objective.

  - For example, study area funding caps (as proposed by the RTF and endorsed by a number of parties) would have precisely the same effect on fund growth as cutting off funding for non-primary lines provided by CETCs, but would be competitively neutral

  - The Joint Board and the FCC should not – and by law, must not – select an anti-competitive policy option such as primary line restrictions when it could accomplish precisely the same objective through a competitively neutral policy.

Myth #7: *Unlike CETCs, ILECs are uniquely subject to "carrier of last resort" (COLR) obligations.*

Fact: Federal law imposes precisely identical "COLR" rules upon both ILECs and CETCs – the rules in Section 214(e), which require CETCs and ILECs alike to provide service to any and all customers throughout their designated service areas.

- Competitive ETCs receive support only if and when customers choose to take service from them. "Cherry picking" is impossible, and there is no evidence that it is actually occurring.

- Other obligations that ILECs mischaracterize as "COLR" obligations are really regulatory means to control ILEC market dominance – *i.e.*, regulation of rates and service quality. Competitive entrants have market incentives to get rates and service quality right – if they charge excessive rates or offer poor service quality, consumers won't sign up for service.

- There is no basis for abusing the ETC designation process to impose ILEC regulations on competitive entrants with no market power. Such efforts are usually thinly disguised attempts to preclude wireless carriers or other new entrants from seeking ETC designation or competing in the first place.

- The FCC's rules, developed based on a Joint Board recommendation, provide a process for state commissions to redraw the study area boundaries of rural telcos. Some state commissions are following this established process in order to ensure that rural ILECs' "gerrymandered," arbitrary study area boundaries do not pose an artificial barrier to entry.

Myth #8: ***The So-Called "Rural Difference":*** *Rural ILECs are different from other carriers, and therefore deserve to continue receiving substantially more USF support.*

Fact: There <u>*are*</u> differences between rural areas and other geographic areas – it costs more to serve areas where the population is sparse, whether using wireline or wireless technology. **But there is no inherent difference between rural ILECs and other carriers**, and therefore no principled reason to provide different amounts of USF funding to rural ILECs, so-called non-rural ILECs, or CETCs, if the carriers serve similar or identical geographic areas.

- Regulation should be neutral on the issue of carrier identity and size, and certainly should not reward a carrier just for being small – or just for owning an entity with a traditionally small, but entirely arbitrary, "study area" definition. To do so serves no legitimate purpose and creates skewed and uneconomic incentives.
    - The only reason that larger ILECs are selling exchanges to rural ILECs, rather than the other way around, is the perverse and uneconomic incentives generated by the different USF support systems in place.
- The notion that some geographic locations cannot support multiple providers is unfounded. Even in the most rural, sparsely populated areas, both wireline and wireless carriers may be able to achieve economies of scale by serving multiple areas using common equipment, and through other measures.
- Rural ILECs are not at risk of shriveling up and dying upon entry of CETCs that receive USF support. To the contrary, rural ILECs today are one of the most successful sectors of the telecom industry. Not a single ILEC has ever withdrawn from a market due to wireless CETC entry.